BRIEFING PAPER

TICAS
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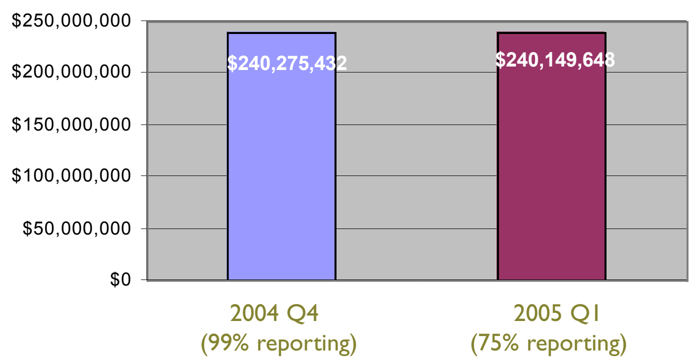
STUDENT LOAN COSTS RISE DESPITE NEW LAW
9.5% Loophole Payments Higher than Before Reform

Five months ago, after excessive federal payments to student loan companies caused a public outcry, Congress passed a law intended to stop the program that guaranteed lenders a 9.5 percent return on some loans. Allowing the payments in the first place was "unfair to taxpayers and unfair to students," according to one coauthor of the reform legislation. "When you boil it down, it is just plain bad policy." The other coauthor said the legislation was "a straightforward plan to shut down excess subsidies," part of an effort to "permanently end" the controversial payments.

But stopping the bleeding of taxpayer dollars has turned out not to be so straightforward. Despite President Bush's October 30, 2004, signature creating Public Law 108-409, the 9.5 percent interest payments to loan companies continue to climb.

Quarterly Taxpayer Payments to Student Loan Companies Holding 9.5% Loans, Before and After Public Law 108-409



Even with a fourth of the invoices still outstanding, the U.S. Department of Education has already paid student loan companies, in the first quarter of the current fiscal year, 99.9 percent of the amount taxpayers paid in the final quarter of the prior fiscal year, before Congress passed the new law. When all the invoices are in, the total payments will almost certainly exceed any prior quarter since the 9.5 percent guarantee was enacted 25 years ago.

Section 438(b)(2)(B) of the Higher Education Act of 1965, as amended

(B)(i) The quarterly rate of the special allowance for holders of loans which were made or purchased with funds obtained by the holder from the issuance of obligations, the income from which is exempt from taxation under Title 26 shall be one-half the quarterly rate of the special allowance established under subparagraph (A), except that, in determining the rate for the purpose of this clause, subparagraph (A)(iii) shall be applied by substituting "3.5 percent" for "3.10 percent". Such rate shall also apply to holders of loans which were made or purchased with funds obtained by the holder from collections or default reimbursements on, or interests or other income pertaining to, eligible loans made or purchased with funds described in the preceding sentence of this subparagraph or from income on the investment of such funds. This subparagraph shall not apply to loans which were made or insured prior to October 1, 1980.

(ii) The quarterly rate of the special allowance set under clause (i) of this subparagraph shall not be less than 9.5 percent minus the applicable interest rate on such loans, divided by 4.

(iii) No special allowance may be paid under this subparagraph unless the issuer of such obligations complies with subsection (d) of this section.

(iv) Notwithstanding clauses (i) and (ii), the quarterly rate of the special allowance for holders of loans which are financed with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, or refunded after September 30, 2004, and before January 1, 2006, the income from which is excluded from gross income under the Internal Revenue Code of 1986, shall be the quarterly rate of the special allowance established under subparagraph (A), (E), (F), (G), (H), or (I), as the case may be. Such rate shall also apply to holders of loans which were made or purchased with funds obtained by the holder from collections or default reimbursements on, or interest or other income pertaining to, eligible loans made or purchased with funds described in the preceding sentence of this subparagraph or from income on the investment of such funds.

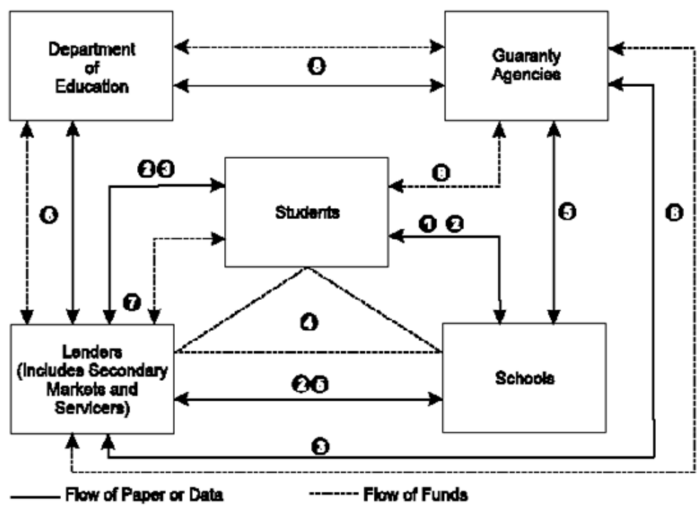
It is not yet clear why the payments have not abated. But when the reform was being considered, some lawmakers shared the Institute's view that the bill language was not clear or firm enough to prevent continued abuse.

Part of the problem with the new law is that it allowed "recycling" of loans carrying the excess subsidies. Under this provision, the loan companies can create new loans carrying the 9.5 percent guarantee by using profits from prior 9.5 percent loans as capital. The law gives the favorable interest rate treatment to new loans made from "collections or default reimbursements on, or interest or other income pertaining to" prior loans carrying the 9.5 percent guarantee. The lure of such large, taxpayer-assured returns is an invitation to abuse, and the reason for the ballooning taxpayer payments to lenders over the past two years.

One lawmaker who proposed a more comprehensive approach predicted "the abuse will continue. New loans will be made to new students that taxpayers will subsidize at a 9.5 percent interest rate. It's madness. We should be allowing older borrowers to refinance their student loans at today's market rates, instead of subsidizing big banks at the high interest rates of the 1980s. We should be helping students who are eligible for Pell Grants, instead of subsidizing big banks needlessly."

Complicated Processes, Structural Flaws, and Management Shortcomings Cause Student Aid Program Problems

Figure 2: Applying for and Repaying an FFELP Loan



Source: U.S. General Accounting Office, High-Risk Series: Student Financial Aid, February, 1997

The weakness of Congress's reform law also caught the eye of the Congressional Budget Office. In its February 2005 list of potential ways for reducing the deficit, CBO includes a proposal that would end recycling of 9.5 percent loans. Doing so, according to the report, would save $930 million over five years on top of the savings from the simple extension of the partial reform that Congress already enacted.

Part of a larger problem

In the government-guaranteed student loan program, thousands of corporate and government entities enjoy, by law, a contractual right of payment from the U.S. government. These promises are all part of an effort to lubricate the system with enough cash so that students ultimately get the loans they need.

But these many entitlements, promised to thousands of intermediaries, are set and adjusted through the congressional policy-making process, without the benefit of competitive market forces. Furthermore, if one of these politically set payments turns out to over-compensate the intermediary, the Secretary of Education is often unable to do anything about it. And these intermediaries work hard to ensure that Congress is not eager to make the program more efficient.

The 9.5 percent guarantee was first created by a law passed in 1976, when interest rates were in the double digits, to ensure that there would be enough college loan money for all eligible students. Originally, the 9.5 percent loans could be issued only by nonprofit state agencies. Over the years, however, many of these were taken over by for-profit companies that then were able to take advantage of the guaranteed 9.5 percent rate.

Congress tried to repeal the 9.5 percent rate in 1993, and the loans began to dissipate, as expected. But the 1993 law included a grandfather clause: loans "made or purchased" with pre-1993 tax-exempt bonds would continue to get the 9.5 percent rate. Two years ago, as interest rates reached historic lows, some student loan companies devised a scheme to exploit the grandfather clause. They argued that even if a loan was "purchased" with bond proceeds and then sold the next day, it would retain the favorable 9.5 percent subsidy. Thereby, through a process of briefly dipping new loans into the pool of old tax-exempt bond funds, lenders produced billions of dollars of additional claims on the highly profitable 9.5 percent subsidies.

The U.S. Department of Education could have taken action to prevent the abuse, but on the advice of a top political appointee (who has since left to work for a student loan company) the agency took no action. So Congress stepped in. Now, it appears, the Secretary of Education will have to turn off the spigot, or Congress will have to try again.

Timeline: 9.5% Student Loans

1976 – To ensure that students have access to college financing, the Tax Reform Act of 1976 encourages states to issue tax-exempt bonds to finance student loans. States begin establishing student loan authorities that issue both tax-exempt and taxable bonds, which become highly profitable at taxpayers' expense.

1980 – Intending to limit government payments to lenders at a time of high interest rates, Congress passes a new subsidy formula guaranteeing a minimum return of 9.5% on student loans financed with tax-exempt bonds.

1986 – A Congressional Budget Office study finds that student loan authorities remain "substantially more profitable" than commercial banks due to the 9.5% guarantee.

1993 – Omnibus Budget Reconciliation Act of 1993 eliminates 9.5% guarantee for new student loan bonds, but a "grandfather clause" keeps the guarantee for pre-existing bonds and loans made with collections from earlier loans.

1997 – Student loans made from tax-exempt loan funds begin being transferred to for-profit lenders.

1998 – U.S. Department of Education proposes repeal of 9.5% loan provisions.

Fall 2002 – Investigators for the U.S. Department of Education alert officials in Washington, D.C., to a lender's scheme to expand holdings of 9.5% loans. Investigators request permission to order the lender to stop. Instead, officials order the investigation closed without raising the 9.5% loan scheme as an issue.

June 2003 – Department of Education receives letter from for-profit lender, Nelnet, declaring its intention to bill taxpayers for 9.5% loans funded by qualifying tax-exempt bonds for as little as one day. The letter requests clarification as to the legality of the scheme. The Department does not respond.

October, 2003 –

Congressional Research Service, in memorandum requested by Sen. Edward Kennedy, documents rising cost of 9.5% loans.

U.S. News & World Report cites the 9.5% loans as a problem in front-page expose, "Big Money on Campus: How Taxpayers are Getting Scammed by Student Loans."

Reps. Dale Kildee and Chris Van Hollen ask the Government Accountability Office to review the 9.5% loan situation.

Sen. Edward Kennedy and others introduce legislation that includes a full repeal of the 9.5% loan provisions (S.1793).

February 2004 – President Bush's 2005 Budget submission to Congress says that the "significantly lower" government costs in the direct loan program "call into question the cost effectiveness of the FFEL program structure." The Budget cites the 9.5% loans as one example of "unnecessary subsidies," and calls on Congress to end them.

May 2004 – Reps. John Boehner and Howard ("Buck") McKeon introduce legislation that includes partial closure of 9.5% loopholes (H.R. 4283).

June 2004 – Department of Education replies to letter it received from Nelnet more than a year before (see June 2003). The reply does not declare Nelnet's actions as either legal or illegal, appropriate or inappropriate.

July 2004 –

Nelnet issues news release announcing that it will fully recognize income from cloned 9.5 loans due to "clarifying information" received pursuant to a request for clarification from the U.S. Department of Education. Nelnet's stock price rises more than 20%. The Institute for College Access and Success (TICAS) files Freedom of Information Act request with the Department for documents relating to Nelnet's announcement.

August 2004 –

GAO briefs congressional requesters on its draft findings regarding 9.5% loans.

Reps. Kildee and Van Hollen and Sen. Kennedy call on the Secretary of Education to close the loophole immediately and transfer the subsidy payments to financial aid programs for college students.

TICAS releases "Money for Nothing," a report on 9.5% loans. The report discloses the Nelnet letter to the Education Department warning of the cloning plan in June 2003.

New York Times article discloses GAO and TICAS findings.

Sen. John Edwards (who had proposed student loan reforms a year earlier) calls on the White House and Department of Education to close the 9.5% loophole, asserting that they have the authority to do so.

September 2004 –

Jamienne S. Studley, president of Public Advocates and former Education Department General Counsel, tells the Secretary of Education that he does have the authority to immediately stop some of the 9.5% abuses.

Reps. Kildee and Van Hollen propose an amendment aimed at closing the 9.5% loopholes for a year (the duration of the appropriations bill that they were amending). The amendment passes 413-3.

Sen. Patty Murray, proposes an amendment in the Senate Appropriations Committee to stem the 9.5% costs. The amendment fails.

The Government Accountability Office releases final report, "Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments." The report confirms that the Department of Education could do more to avert 9.5% costs, even without congressional action.

Rep. John Boehner and others introduce H.R. 5186, the Taxpayer-Teacher Protection Act of 2004. The bill includes a partial, temporary closure of the 9.5% loophole, and uses the taxpayer savings to forgive student loans for teachers serving disadvantaged students.

October 2004 – H.R. 5186 is passed by the House and by the Senate, and is signed by President Bush, becoming Public Law 108-409.

January 2005 –

Congressional Budget Office finds that legislation by Reps. Tom Petri and George Miller would transfer $12 billion from inefficiencies in the student loan program to grants for low-income students, without increasing federal spending.

President Bush endorses the idea making the student loan program more efficient, and using the savings to increase grants for students.

February 2005 –

President Bush's budget calls for $4.4 billion in reductions in subsidies to student loan companies over five years.

House committee leadership announces its opposition to the President's proposed reductions in lender subsidies.

Budget of the U.S. Government, Fiscal Year 2006

The following chart compares total FFEL and Direct Loan costs on a subsidy rate basis: program costs calculated under the Federal Credit Reform Act of 1990 and comparably projected estimates of Federal administrative costs, including expenses related to FFEL program oversight and servicing the Direct Loan portfolio. As with any long-term projection, the comparison is based on assumed future interest rates, borrower characteristics, administrative costs, and other factors over the life of the loan cohort. To the degree actual conditions differ from projections, estimated subsidy rates will change.

Student Loan Program Costs: Comparative Analysis Including Program and Administrative Activities (in thousands of dollars)

	2004 actual	2005 est.	2006 est.
FFEL			
Program costs:[1]			
Interest subsidies	13.01	13.48	10.28
Interest income	0.00	0.00	0.00
Net defaults	1.06	0.91	0.83
Fees	−5.42	−5.15	−5.53
Other	2.74	2.72	2.64
Total	11.40	11.96	8.22
Federal administrative costs	0.69	0.69	0.69
Total	12.09	12.65	8.91
Total adjusted cost:			
Direct Loans			
Program costs:[1]			
Interest subsidies and income, net	−5.62	−5.52	−8.12
Net Defaults	1.70	1.48	1.71
Fees	−2.02	−1.98	−2.17
Other	5.33	5.49	5.06
Total	−0.61	−0.53	−3.51
Federal administrative costs	1.45	1.45	1.45
Total adjusted cost	0.84	0.92	−2.06

THE BOTTOM LINE

Government-guaranteed loans cost taxpayers **12 cents** on the dollar.

Direct loans cost taxpayers less than **1 cent** on the dollar.